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FOREIGN INVESTMENT IN INDIA FROM NEIGHBORING COUNTRIES: CROSSING THE CHASM BETWEEN INTENT AND IMPACT

INTRODUCTION

On April 17, 2020, the Government of India ("**Government**") issued Press Note No. 3 (2020 Series) ("**PN3**") with an objective to limit 'opportunistic' foreign direct investments ("**FDI**") from countries sharing land border with India ("**Neighbouring Countries**").[1] The PN3 mandated that where an investing entity is situated in a country sharing land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country, FDI shall be permitted only with prior Government approval.

Against the backdrop of the pandemic and concerns of Chinese consolidation of investment in Indian entities, the PN3 aims to protect vulnerable Indian companies from foreign takeovers. The issuance of PN3 has been followed by a series of amendments across various Indian laws to streamline the extant legal framework. Given that India generally strives to maintain close ties with its Neighbouring Countries, the PN3 is a *prima facie* contrasting development to its recent approach to international relations.

In light of PN3's over two-years' tenure, this article delves upon the divide between the legislative intent and the consequent impact, similar global developments and reflects on whether this framework needs any modifications.

IMPACT OF PN3: HAS THE JOURNEY BEEN SMOOTH?

The Indian Council on Global Relations, in its report, stated that in February 2020, 18 of the 30 Indian unicorns received funding from Chinese investors.[2] The onset of the pandemic prompted concerns about the likelihood of such investments eventually leading to foreign control of Indian entities, thereby hampering national interest. Primarily intended to address this concern and in light of the then prevailing geo-political scenario between India and its neighbouring countries, issuance of PN3 possibly became the most tactful way to preserve the Indian-ness of the Indian entities. The journey since then has had its ups and downs.

PN3 subjects all foreign direct investments made by investors of Neighbouring Countries, or transactions where the 'beneficial owner' is either domiciled in or is a citizen of a Neighbouring Country, to prior screening and approval by the Government.[3] Unfortunately, PN3 does not define the scope of the term 'beneficial owner'. Since there is no clarity at present on how this is to be construed, it remains a matter of subjective and at times convenient interpretation, given different thresholds are provided under different Indian laws with nomenclatures such as 'ultimate beneficial owner' ("**UBO**") and 'significant beneficial owner' ("**SBO**"). While the PN3 has been brought up in the general discussions in the Lok Sabha (House of the People), no clarifications have been issued by the Government in this regard.[4]

The government has in fact gone one step ahead in terms of restricting entities from Neighbouring countries to participate in public procurement contracts in India until they are registered with the Department for Promotion of Industry and Internal Trade ("**DPIIT**").[5]

Even after 2 years into the new regime, the acceptance or denial of an FDI remains at the behest of the Government. Statistically, the approvals granted have been low, with the Government having approved only 66 out of 347 investment proposals from Neighbouring Countries as of March 2022.[6]

PN3 SETTING FDI BOUNDARIES: IS INDIA THE ONLY ONE?

While few jurisdictions already had a framework in place for regulating any foreign investment that may affect national interests, others made significant changes to their policies as a response to the economic effects of the pandemic. The European Union ("**EU**") and United States of America ("**USA**") are examples of the former, while Australia, New Zealand, and the United Kingdom ("**UK**") come under the latter bracket.

Pre pandemic frameworks

The EU framework for screening of foreign direct investments entering into EU ("**Screening Mechanism**") is a procedure governing the authorization of FDI into European nations with the aim of preventing threats to national security and public order. It not only empowers the EU Commission to issue "opinions" on inward transactions involving FDI within the territory of any of the EU member states from non-EU countries, but also prepares an exhaustive list of criteria for domestic screening by Member States.[7]

The regulation establishing this Screening Mechanism was adopted in March 2019 by the European Parliament and

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Council, and was to become fully applicable to all Member States from October 2020.[8] However, being alarmed by the increasing Chinese interest in EU companies in the aftermath of the pandemic, the EU was quick to issue the Press Release dated March 25, 2020, urging Member States to undertake rigorous screening of all foreign investments that can impact national security.[9] This led to an agreement amongst Member States to share all information on FDI transactions that can affect the EU as a single market.[10]

With respect to the USA, the Committee on Foreign Investment in the United States ("**CFIUS**") enacted the Foreign Investment Risk Review Modernization Act in 2018 ("**FIRRMA**") to address national security concerns through foreign investments. FIRRMA prescribes filing requirements for investments in certain sectors and entities, with CFIUS reviewing investments pursuant to this law. The CFIUS assesses the potential "threat" of the foreign investors, the "vulnerability" of the domestic business and national security implications of FDI entering USA.[11]

Post pandemic amendments

In December 2020, Australia passed the Foreign Investment Reform (Protecting Australia's National Security) Act, 2020 to amend the Foreign Acquisitions and Takeovers Act, 1975 and introduced a mandatory approval requirement for any proposed acquisition by a foreign person of a direct interest (10% or more) in a "national security business".[12] Additionally, the Treasurer was provided with powers to review any investment (that may or may not be subject to mandatory approval) for "national security" concerns.[13]

New Zealand amended the New Zealand Overseas Investment Act, 2005 to impose mandatory notification requirements on all foreign investments resulting in acquisition of an interest of 25% or more, or increasing of an existing interest in a New Zealand business above prescribed thresholds.

Similarly, UK[14] has also increased regulatory involvement in investments relating to specified sectors by mandating prior approval and compulsory filings for most types of acquisitions.

Notably, the above measures seem to differ from the policy envisaged under India's PN3. While the above-highlighted steps mostly seem to apply to all foreign investments agnostic of any particular nation or a group of nations, the PN3 envisages targeted investments which indicates a conscious policy measure of the Government to reduce dependence on, *inter alia,* the Chinese investments, which account for the largest made by any of India's Neighbouring Countries.

SHOULD PN3 BE REVISITED?

Given the current challenges faced by foreign investors at large, and importantly, the Indian investee entities who are looking for foreign investment, the Government should consider revisiting PN3 to provide clarity in certain aspects.

Given the lacunae under the PN3, at times, most innocuous of the foreign investments are caught in the net. So much so that the Indian banks while performing due diligence often object to FDI by a foreign entity with a listed parent entity having Chinese investors. Moreover, large M&A deals in the manufacturing sectors which aim to boost the Indian economy and generate employment get stalled on account of the PN3 restrictions.

The clarity is also needed on the stage at which the approval application should be filed with the Government. Let's say, an India focussed offshore fund has investors pooling in it from across jurisdictions, including China. In such a case, it would make sense for the fund to file a one-time PN3 application with the Government at the time of admission of the Chinese investor in the fund instead of seeking approval each time the fund (having such Chinese investor) is looking to make investment in an India company. Any clarity on this would help the offshore fund managers in determining their investor base.

Further, the PN3 makes no distinction between "direct" and "indirect" transfers, due to which indirect transfers at an offshore level, which would otherwise have no impact on the Indian entity, also come under the purview of PN3. Furthermore, funding by the overseas parent entities of their existing subsidiaries doing business in India are also getting obstructed, despite such subsidiaries being established in the pre-PN3 era.

Additionally, the Government needs to prescribe the threshold for beneficial ownership. Considering that the SBO under the Indian Companies Act, 2013 applies to an investor holding 10% or more,[15] and UBO under the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 applies to an investor holding more than 25% in case of a company and 15% in other cases,[16] it is imperative that the Government clarifies on the threshold applicable to an investor under the beneficial ownership criteria. Also, while it is understood that the PN3 restriction applies not just to the immediate FDI investors but also to their ultimate parent (including the UBOs, i.e. the individual shareholders), it is not clear if the intermediate entity in a group structure also needs to comply with the PN3 guidelines.

Further, there is a need to streamline the reviewal and decision-making process concerning PN3 applications. The Government may consider prescribing the timeline within which an approval application should be closed along with a mechanism to provide an applicant with periodic updates on the status of the application in order to ensure greater transparency and assist honest investors in making informed decisions. In the event that an application is rejected, reasons consistent with the legislative intent behind PN3 and specific to the nature of the FDI should be provided.

CONCLUSION

From being heralded as a pandemic response to becoming an institutionalised FDI policy, the PN3 has come a long way in its journey. While it is an important policy measure that seeks to prevent damage to national interest, certain ambiguities prevailing in its framework have unfortunately proved to be detrimental to *bona fide* neighbouring investors seeking entry into one of the world's most promising economy, India. Clarity along the above lines can be provided by the Government to the PN3 framework without compromising on its intent on the PN3 policy.

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[1] Press Note No. 3 (2020 Series), *Ministry of Commerce and Industry*, available at:

https://dpiit.gov.in/sites/default/files/pn3_2020.pdf.

[2] "Report: Chinese Investment In India", *Gateway House*, available at: https://www.gatewayhouse.in/wp-content/uploads/2020/03/Chinese-Investments-in-India-Report_2020_Final.pdf. Interestingly, Chinese investments (amounting to USD 2.45 billion) only had a 0.43% share in total FDI equity inflow into India from April 2000 to December 2021. *For further details, please see* Investment from Land Border Sharing Countries, *Ministry of Commerce & Industry*, available at: https://pib.gov.in/PressReleasePage.aspx?PRID=1808806.

[3] *Supra* note 1.

[4] Investment from Land Border Sharing Countries, *Ministry of Commerce & Industry*, available at: https://pib.gov.in/PressReleasePage.aspx?PRID=1808806. Also, the Government, vide notification dated December 8, 2022 (E-gazette notification dated 8 December, 2022, Proviso to Rule 2, *Ministry of Finance*; available at: https://egazette.nic.in/WriteReadData/2020/223577.pdf), clarified that multilateral banks or funds would not be considered as an entity of any particular country, hence removing the requirement for approval owing to "beneficial ownership",

[5] Insertion of Rule 144 (xi) in the General Financial Rules (GFRs), 2017, Office Memorandum F. No. 6/18/2019-PPD, *Ministry of Finance*, available at: https://doe.gov.in/sites/default/files/OM%20dated%2023.07.2020.pdf.

[6] FDI from neighbouring countries, *Ministry of Commerce & Industry*, available at: https://pib.gov.in/PressReleasePage.aspx?PRID=1806626.

[7] See Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019.

[8] "EU foreign investment screening mechanism becomes fully operational", *European Commission*, available at: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1867.

[9] "Coronavirus: Commission issues guidelines to protect critical European assets and technology in current crisis", *European Commission*, available at: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_528.

[10] Supra note 8.

[11] 31 CFR, Section 800.801 (USA).

[12] "National security business" broadly encompasses the following: (i) 'Responsible entities' and 'direct interest holders' of critical infrastructure assets, within the meaning of the Security of Critical Infrastructure Act 2018, and 'carriers' and 'carriage service providers' to which the Telecommunications Act 1997 applies; (ii) Businesses that develop, manufacture or supply critical goods, technologies or services that will be used (or are intended for use) by defence and intelligence personnel, or the defence force of another country, in activities that may affect Australia's national security; or (iii) Businesses that own, store, collect or maintain classified data, or personal data relating to Australia's defence and intelligence personnel that, if disclosed or accessed, could compromise Australia's national security. *For further details, please see* "Australia's Foreign Investment Policy", as provided by the Australian Treasury at https://firb.gov.au/sites/firb.gov.au/files/2021-01/Australias_foreign_investment_policy.pdf.

[13] Foreign Investment Reform (Protecting Australia's National Security) Act 2020 (Cth).

[14] National Security and Investments Act, 2021 (UK).

[15] Section 90, (Indian) Companies Act, 2013.

[16] Rule 9, The Prevention of Money Laundering (Maintenance of Records) Rules, 2005.

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